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RUEHMN/AMEMBASSY MONTEVIDEO 2713
RUEHLP/AMEMBASSY LA PAZ 3820
RUEHSG/AMEMBASSY SANTIAGO 2409
RUCPDOC/USDOC WASHDC 3100
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UNCLAS SECTION 01 OF 04 SAO PAULO 000269

SENSITIVE
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STATE FOR WHA/BSC, WHA/EPSC
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STATE FOR OES/EGC DREW NELSON
STATE FOR OES/PCI FOR LARRY SPERLING
NSC FOR FEARS AND DAVID MCCORMICK
DOE FOR GWARD, AKARSNER, BBARTON
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USDOC FOR 3134/ITA/USCS/OIO/WH/RD/DRAMBO
STATE PASS USTR FOR KATE DUCKWORTH
TREASURY FOR JHOEK

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TAGS: [ENRG](#) [EAGR](#) [ELTN](#) [ETRD](#) [TRGY](#) [BTIO](#) [BR](#)
SUBJECT: BRAZILIAN BIOFUELS: ETHANOL PRODUCTION EXPANDING

REF: A) SAO PAULO 207, B) SAO PAULO 227, C) BRASILIA 656

11. (U) SUMMARY: Soaring petroleum prices and a rapidly growing domestic fleet of flex-fuel cars are driving double-digit expansion in ethanol production in Brazil. In the coming year alone, Brazil's production of sugarcane-based ethanol is projected to increase 14.8 percent. Domestic demand for ethanol is large and growing, currently consuming 85 percent of all production. The other 15 percent is exported, primarily to the United States. The ethanol private sector in Brazil is increasingly partnering with international companies in building production facilities, both in and out of Brazil, as well as addressing the internal logistics problems that undermine the potential profitability of Brazilian ethanol exports. Infrastructure bottlenecks in Brazil, as well as various international tariff regimes, will likely continue to pose hurdles to the expansion of Brazilian ethanol exports and the internationalization of ethanol as a commodity. END SUMMARY.

DOUBLE-DIGIT GROWTH IN SUGAR AND ETHANOL PRODUCTION

12. (U) According to the USDA's Agricultural Trade Office in Sao Paulo (ATO), both sugar and ethanol production is expected to increase during the current market year (MY) corresponding to May 2008 to April 2009. During this period, land dedicated to sugarcane cultivation is projected to expand by 12 percent from 7.19 million hectares to 8.05 million, equivalent to approximately 2.3 percent of Brazil's arable land. An increasing percentage of that sugarcane is projected to go towards ethanol production instead of sugar (56.5 percent in MY 2008/2009 vice 54.5 percent in MY 2007/2008). In absolute terms, ethanol production for MY 2008/2009 is projected to see a 14.8 percent increase (25.71 billion liters vice 22.39). (Note: Sugarcane is currently the sole feedstock for ethanol in Brazil. End Note.)

¶3. (U) Much of Brazil's ethanol production continues to be destined for the domestic market, with domestic demand expected to rise 16.2 percent in MY 2008/2009 (22.05 billion liters vice 18.97). The expanding fleet of flex fuel vehicles, which today account for 90 percent of new car sales, explains the expanding domestic demand (Ref A). In the month of April, for the first time in 20 years, sales of ethanol surpassed gasoline in Brazil.

Largely due to fuel demand, in 2007, sugar and its derivatives passed hydro power as the second largest source of energy in Brazil, contributing 16 percent of Brazil's overall energy matrix (compared to petroleum at 36.7 percent and hydro at 14.7 percent). In 2007, bioelectricity accounted for three percent of Brazil's electricity (1,400 megawatts). The Brazilian Sugarcane Industry Association (UNICA) predicts that given the proper government incentives to tie into the main power grid, this number could increase to 11,500 megawatts by 2015 and 14,400 megawatts by 2021 - equivalent to 20 percent of Brazil's electricity usage today.

ETHANOL EXPORTS: PRESENT & FUTURE

¶4. (U) For over thirty years, Brazil has been by far the world's largest producer of ethanol from sugarcane. Correspondingly, it has been and remains today the world's largest exporter of ethanol. According to the Brazilian Secretariat of Foreign Trade (SECEX), major export markets for 2007 included the U.S. (841 million liters), Holland (793 million liters) and Japan (363 million liters). Exports to Caribbean and Central American countries

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(Jamaica, Costa Rica, El Salvador and Trinidad & Tobago) amounted to 910 million liters. Virtually all of this volume was then re-exported to the United States under the Caribbean Basin Initiative (CBI) and CAFTA-DR tariff concessions after going through the process of dehydration. (Note: These numbers are inconsistent with U.S. census data that shows ethanol imports from Brazil of 714 million liters in 2007. End Note.)

¶5. (U) Despite the negative perceptions in some international quarters about the role of biofuels in contributing to food inflation (Ref B), concerns about the environmental impact of ethanol production, and allegations of precarious working conditions of sugarcane workers (septel) - Brazilian sugar and ethanol producers see growth potential in the export market, apart from the rising domestic demand. ATO projects that Brazil will export 3.9 billion liters in MY 2008/2009, a 13 percent increase over MY 2007/2008. Other interlocutors also see high oil prices further supporting ethanol exports to the U.S. - both direct and through the CBI countries. The Brazil Renewable Energy Company (Brenco) told Econoff that conservative analysts believe ethanol will remain competitive in the international market vis-`-vis gasoline at least as long as petroleum costs exceed USD 70 to 80 per barrel.

¶6. (U) Brazilian exporters believe there is significant international market potential in the blending of ethanol with gasoline, particularly the E10 blend (90 percent gasoline and 10 percent ethanol) and possibly as much as E25 (75 percent gasoline and 25 percent ethanol). Brenco is largely basing their business model on exporting ethanol as a partial fuel substitute. Even in countries that do not have a significant number of flex-fuel cars, ethanol can be blended up to a certain level with gasoline and run in standard gasoline engines without the need to overhaul the downstream infrastructure or modify vehicle engines.

¶7. (SBU) Brazilian industry experts are concentrating particularly on the U.S. market, largely because they believe that the U.S. will not be able to reach Congressional and Executive branch mandates for ethanol or biodiesel production of 36 billion gallons by 2022. According to Plinio Nastari (editor of the leading ethanol industry newsletter), and Roberto Gianetti da Fonseca (associated with Ethanol Trading SA and the Federation of Industries of the State of Sao Paulo, FIESP), U.S. domestic production will peak at 15 billion gallons given current technology. Some Brazilian ethanol exporters, and especially Gianetti da Fonseca, argue for a change in U.S.

policy that would allow for tariff-free access to the U.S. market for E85 blends to fuel the growing U.S. fleet of flex fuel vehicles.

(Comment: While most ConGen contacts are critical of the ethanol tariff, the sentiment is not universal. Miguel Dabdoub, coordinator for the Biodiesel Brazil Project out of the University of Sao Paulo's Laboratory for Clean Technology Development, argues that the tariff is necessary for a period of time as a mechanism to build up domestic support among the U.S. population and as part of a larger strategy to make ethanol an acceptable alternative globally.

Interlocutors at FIESP have also stated that an immediate removal of the tariff would hurt supply in Brazil as more companies would seek to immediately export to the U.S. Similarly, while many interlocutors at MRE and in Congress urge the immediate removal of the tariff, the Ministry of Agriculture does not urge this point. End Comment.)

INFRASTRUCTURE BOTTLENECKS

¶8. (U) Like in most other sectors of the Brazilian economy, the

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ethanol industry suffers from inadequate infrastructure, the so-called 'Custo Brasil' - costs other than those related to production which significantly increase total cost and affect competitiveness. Custo Brasil is seen along the ethanol production line - from storage to transportation to port handling - and represents an on-going bottleneck in increasing Brazilian ethanol exports. Starting in the countryside at sugar distilleries, ethanol destined for domestic consumption moves by truck (only occasionally by rail or pipeline) to regional distribution centers, then onward to secondary distribution centers, and finally to gas stations. Ethanol producers hold stocks at the distributors' convenience, thus imposing storage costs on mills. Many of the roads utilized to transport ethanol, especially secondary or local roads, are in poor condition. Highways in the main producing areas are often very good, but tolls are expensive. Most of the existing sugar-ethanol transportation routes are essentially unchanged from twenty years ago. According to calculations of Weber Amaral of the Brazilian Center for Biofuels, internal logistics account for 35 percent of ethanol's total cost.

¶9. (U) Ethanol destined for export faces additional bottlenecks upon reaching port. There is a limited amount of port storage dedicated to ethanol, forcing exporters to rent space in multi-use chemical terminals. This limitation of storage capacity represents a significant restraining factor on any increases in ethanol exports. The same obstacle exists in the contracting of vessels. As there is no well-developed large scale international market for ethanol, exporters rely on multi-use chemical tankers. This involves substantial additional costs since storage facilities and tanks must be bid away from other potential users, and be thoroughly cleaned before and after use.

INDUSTRY TRENDS

¶10. (U) These existing obstacles do not seem likely to discourage expansion in the sector as Brazil still produces the cheapest ethanol in the world (22 cents a liter compared to 30 cents for U.S. corn-based and 53 cents for European beetroot ethanol). Several major private sector initiatives aim to substantially increase Brazil's export capacity and reduce transportation costs. Brenco outlined to Econoffs a plan to vertically integrate the entire process in order to control their costs and get their product to market.

¶11. (U) COSAN, Brazil's biggest sugar and ethanol producer, recently announced USD 826 million-deal with Esso (Exxon Mobil Corp.) to purchase all of its 1,500 gas stations in Brazil. According to COSAN, this deal will make them the world's first fully integrated renewable energy company. In April, BP announced a joint venture with Santelisa Vale (the second largest sugarcane crusher), to build and operate two ethanol refineries. This partnership makes BP the

first petroleum company to buy a commanding role in the ethanol market and positions the new company, Tropical Bioenergia, to compete with COSAN for the position of Brazil's leading sustainable renewable fuels supplier of ethanol. Petrobras has also publicly announced the intention to begin construction of a USD 315 million ethanol pipeline in 2009 connecting mills in five states with maritime terminals. (Note: Petrobras enjoys a substantial advantage in building any pipeline, since the new line would be built along rights-of-way where current petroleum and mixed-use pipelines are located. End Note.)

¶12. (U) Many companies that are not making the headlines for the

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marriage of petroleum and biofuels are looking to ramp up their investments in infrastructure in an effort to address existing bottlenecks. In addition to Petrobras, industry leaders such as Crystalsev, Copersucar, and Brenco have all announced export-driven projects to build pipelines to move ethanol from producing regions to port. Brenco's plan calls for a USD one billion investment to build 10 additional refineries and a 700 mile six-terminal pipeline to link its inland refineries with the Port of Santos. This pipeline could potentially halve transportation costs for ethanol to move from inland distilleries to port. The timeframe to build such pipelines depends largely on the growth of worldwide ethanol demand as well as access to credit.

¶13. (U) Port infrastructure remains a contentious subject. While there are several billion-dollar private port projects on the table, all are being held up until the Supreme Court rules on the legality of private companies building and operating ports to move their own goods. Until this issue is resolved, private port investment, including for the ethanol industry, is moving ahead cautiously. Coimex, a Brazilian logistics company that is among those wishing to build a private port, is for the time-being looking to build a liquid terminal for ethanol storage in the Port of Santos. Mining and logistics company Vale (formerly CVRD) - which already uses its extensive railroad, port, and maritime terminals to provide services for Brazilian agriculture - is likewise planning the construction of a maritime terminal in Vitoria in partnership with Oiltanking.

COMMENT

¶14. (U) High oil prices and growing numbers of flex-fuel cars will significantly increase domestic demand for ethanol. This can be expected to continue to drive Brazil's expanded sugarcane cultivation and ethanol production, and any increase in foreign demand will add further pressure to expand production. Ethanol exports face several significant hurdles including domestic Brazilian infrastructure that inhibits increased exports as well as potential fallout in some quarters over the linkage between biofuels and food inflation (Ref C). Other environmental and labor concerns are additional obstacles which could impede the growth of Brazilian ethanol exports. To the extent that Brazil's private sector can be considered a bellwether, a series of recent investment announcements indicate that industry leaders believe that the future of ethanol domestically and for export is bright. END COMMENT.

¶15. (U) This cable has been coordinated with and cleared by Embassy Brasilia and coordinated with the Agricultural Trade Office in Sao Paulo.